Office Supreme Court, U.S.
FILED
JUL 30 1957
JOHN T. FEY, Clerk

No. 265

In the Supreme Court of the United States

OCTOBER TERM, 1957

ROSE PEDONE, EXECUTRIX OF THE ESTATE OF SAM PEDONE, ROSE PEDONE, CHARLES PEDONE, and MARIAN PEDONE, PETITIONERS

v.

THE UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINION BELOW

The opinion of the Court of Claims (R. 53-68; Pet. 9-28) is not yet reported.

JURISDICTION

The judgment of the Court of Claims was entered May 8, 1957 (R. 53, 77; Pet. 9, 40). The petition for a writ of certiorari was filed on July 12, 1957. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255(1).

QUESTIONS PRESENTED

1. Did the Court of Claims err in holding that wage payments made by the taxpayers' partnership to its employees, in violation of the wage stabilization pro-

visions of the Defense Production Act of 1950, were not deductible, as the cost of goods sold or as expenses, in computing income subject to tax?

2. Did Congress exceed its constitutional authority in providing that wage payments made in violation of the wage stabilization provisions of the Defense Production Act of 1950 should be disregarded as cost or expense in computing income under the revenue laws?

STATUTES AND OTHER AUTHORITIES INVOLVED

The relevant portions of the Constitution of the United States, the Defense Production Act of 1950 (Section 405), the Internal Revenue Code of 1939 (Sections 22(a), and 23(a)(1)(A)), Treasury Regulations 118 (Section 39.22(a)-5), and General Order No. 15 of the Economic Stabilization Agency, are set forth in the Appendix, *infra*, pp. 12-15.

STATEMENT

The facts, which are undisputed, are set forth in the stipulation of facts (R. 15-26, 41-51) and in the findings of fact entered by the Court of Claims (R. 69-77; Pet. 29-40). They may be summarized as follows:

During the calendar year 1952, taxpayers[1] were equal partners in Pedone Lathing and Plastering Company, which was engaged in the building construction industry as a plastering contractor. It contracted to apply rough and finish coats of plaster to the interior walls and ceilings of buildings, and employed plasterers and building laborers who applied the coats of

[1] For convenience, Sam Pedone and Charles Pedone will be referred to in this brief as the taxpayers. Sam Pedone is now deceased and his widow is his duly appointed executrix. Rose and Marian Pedone are parties to this suit because they filed joint income tax returns with their husbands.

plaster in the performance of these contracts. The partnership furnished the materials needed to perform these contracts (Pet. 29-30, 35).

In the partnership's return of income for 1952, it claimed $414,248.59 as the cost of goods sold, which sum included amounts paid to persons employed to perform the plastering contracts (Pet. 30, 35). During this period, these employees were subject to the jurisdiction of the Economic Stabilization Agency and the Wage Stabilization Board established under the Defense Production Act of 1950, as amended (Pet. 30-31, 35-37). During 1952, the partnership made payments of wages to its employees in contravention of the Defense Production Act and of the orders and regulations promulgated thereunder, in the approximate total amount of $61,665 (Pet. 31-32, 37-38). However, the partnership had cooperated with the Enforcement Division of the Wage Stabilization Board in cutting back to the legal area rate upon request, and it had been the custom of the partnership to pay premium rates from the time it began operations and the employees' wages had been raised proportionately since then; these were considered mitigating circumstances justifying the disallowance of only $13,535, instead of $61,665 (Pet. 32, 38).

On November 25, 1952, the partnership entered into a stipulation with the Wage Stabilization Board for the issuance of a Certificate of Disallowance agreeing, among other things, to the transmittal of the stipulation to the National Enforcement Commission of the Economic Stabilization Agency, and, without further notice or proceeding, to the issuance and transmittal by this Commission of a Certificate of Disallowance to the Commissioner of Internal Revenue certifying that

for the purpose of calculating deductions or the basis for determining gains of the employer the sum of $13,535 should be disregarded for the partnership's taxable year 1952, the deduction to be charged against the income of the partners (Pet. 32-33, 38-39).

A Certificate of Disallowance was issued and transmitted to the Commissioner of Internal Revenue by the National Enforcement Commission, providing in part as follows (Pet. 33, 39; R. 50-51):

> For the purpose of calculating the deductions of the partnership in its federal income tax information return, the sum of $13,535.00 shall be disregarded for the partnership's taxable year ending December 31, 1952, and said deduction shall be charged therein against the income of the partners, Sam Pedone and Charles Pedone, respectively, from the said partnership for the said taxable year in the proportion of their respective partnership interests, which are as follows: Sam Pedone 50%; Charles Pedone 50%. . .

Taxpayers nevertheless included in their partnership return for 1952 the full amounts paid the employees, including the $13,535. The Commissioner thereupon reduced the partnership's cost of goods sold by $13,535, increased the taxpayers' distributable share of partnership net income, and assessed deficiencies, which were paid on August 9, 1954. Pet. 33-34, 39). Taxpayers filed original and amended claims for refund on November 4 and 5, 1953, respectively, and filed suits for refund after the expiration of six months, no action on the claims for refund having been taken by the Commissioner (Pet. 34, 40). The Court of Claims con-

cluded that the taxpayers were not entitled to recover, and dismissed their petition (Pet. 40).

ARGUMENT

The decision below sustains the Commissioner's assessment of deficiencies against the taxpayers for 1952 resulting from a reduction of the partnership cost of goods sold by $13,535, the stipulated amount of illegal wage payments made in contravention of the Defense Production Act of 1950, and the regulations issued thereunder. Taxpayers attack the Commissioner's action on statutory and constitutional grounds, but their challenges are wholly without substance.

1. Recognizing the need to curb inflationary tendencies during the Korean hostilities, Congress provided for the regulation of wage and salary payments in the Defense Production Act of 1950, thus continuing the policies in effect during World War II under the Emergency Price Control Act of 1942, c. 26, 56 Stat. 23. Section 405(b) of the Defense Production Act of 1950, Appendix, *infra*, pp. 12-13, prohibited an employer from paying, or an employee from receiving, any compensation in contravention of regulations promulgated under the Act, and provided that—

> The President shall also prescribe the extent to which any wage, salary, or compensation payment made in contravention of any such regulation or order shall be disregarded by the executive departments and other governmental agencies in determining *the costs or expenses of any employer for the purposes of any other law or regulation.* [Emphasis added.]

General Order No. 15 of the Economic Stabilization Agency[2] (17 Fed. Reg. 2994, Appendix, *infra*, p. 15) established the policy of disallowing these illegal wage payments in "Calculating deductions or the basis for determining gain under the Revenue Laws of the United States." See also I. T. 4105, 1952-2 Cum. Bull. 93.

Taxpayers appear to urge (Pet. 7-8) that Section 405 (b) of the Defense Production Act, *supra*, is inapplicable to their case because it relates, insofar as income taxation is concerned, only to illegal wages claimed as deductions under Internal Revenue Code Section 23(a)(1)(A), Appendix, *infra*, p. 14, as ordinary and necessary expenses of the business (but not part of the cost of goods sold), and not at all to illegal wages claimed to be part of the partnership's capital costs which, it is said, must be recovered before any income tax may be imposed. But, as the Court of Claims pointed out, under the explicit provisions of the statute and the regulations the right of the Government is clear to reduce the amount of the cost of goods sold by the amount of the payments made in violation of law. Congress did not limit the scope of the Defense Production Act to deductions which are not part of the cost of goods sold, but made broad general reference to "costs or expenses," whether a part of the goods sold or otherwise. Wages paid in contravention of the Act and the regulations were thus declared as a matter of law to constitute unreasonable compensation and to be disre-

[2] Executive Order 10161 (15 Fed. Reg. 6105) created the Economic Stabilization Agency and provided that the functions conferred on the President by Title IV of the Defense Production Act were delegated to the Administrator of the Agency.

garded in computing taxable income. Congress established the rigid criterion that, as a matter of public policy, such payments should not be allowed as an expense of doing business. To ignore that criterion would result in the direct frustration of the underlying public policy of the Act, and, as the Court of Claims pointed out, would permit a taxpayer to benefit by the improper payment through a reduction in his income tax. See *Lilly* v. *Commissioner*, 343 U.S. 90.

The result should not depend upon whether the taxpayer itemizes the illegal wages as an expense representing compensation paid to employees, or whether, as in this case, it includes the wages in its cost of goods sold. In both instances, net income would be reduced, and it is clear that items included in the cost of goods sold may be questioned in arriving at net income. See *American Pitch Pine Export Co.* v. *Commissioner*, 188 F. 2d 721 (C.A. 5th); *Majestic Securities Corp.* v. *Commissioner*, 120 F. 2d 12 (C.A. 8th).

Taxpayer's argument has been rejected, in effect, by the Sixth Circuit in *Weather-Seal Manufacturing Co.* v. *Commissioner*, 199 F. 2d 376, affirming, *per curiam*, 16 T.C. 1312. See also *Solon Decorating Co.* v. *Commissioner*, decided February 28, 1957 (1957 P-H T. C. Memorandum Decisions, par. 57,035); and *Zehman* v. *Commissioner*, 27 T.C. No. 107, both pending on appeal in the Sixth Circuit. See also *Gilmore* v. *United States*, 131 F. Supp. 581 (N.D. Calif.); *N. A. Woodworth Co.* v. *Kavanagh*, 102 F. Supp. 9 (E.D. Mich.), affirmed, *per curiam*, 202 F. 2d 154 (C.A. 6th); and *Binder* v. *Commissioner*, decided May 27, 1953 (1953 P-H T.C. Memorandum Decisions, par. 53,183). The *Weather-Seal Manufacturing Co.* case, *supra*, spe-

cifically held that, regardless of whether the illegal wage payments were reported on the taxpayer's return as part of the cost of goods sold or otherwise as a deduction from gross income, wages constitute compensation for personal services rendered and, under Code Section 23(a)(1)(A), Appendix, *infra*, p. 14, they are deductible from gross income only if reasonable and lawful in amount.

Such cases as *Commissioner* v. *Weisman*, 197 F. 2d 221 (C.A. 1st), and *Sullenger* v. *Commissioner*, 11 T.C. 1076,[3] relied on by the dissenting opinion below (Pet. 23-24), and *Woodside Acres* v. *Commissioner*, 134 F. 2d 793 (C.A. 2d), relied on by the taxpayers (Pet. 8), are clearly not in point. In *Weisman*, the First Circuit expressly distinguished a situation involving illegal wage payments specifically forbidden by the Defense Production Act of 1950 from one which involved the inclusion in the cost of goods sold of payments for materials (in the taxable year 1944) in excess of lawful ceiling prices—an action which was then not illegal. The *Woodside Acres* case did not involve the allowance of a tax deduction, as here, but rather the determination of the amount of gross income of a dairy farm for the purpose of ascertaining statutory percentages which would, in turn, decide the question whether or not the taxpayer corporation was a personal holding company.

2. Taxpayers also erroneously argue (Pet. 6) that, if the Defense Production Act of 1950 is interpreted to disallow part of the partnership's cost of goods sold, the Act is unconstitutional as countenancing a tax not

[3] See also *Jones* v. *Herber*, 198 F. 2d 544 (C.A. 10th); and *Hofferbert* v. *Anderson Oldsmobile Co.*, 197 F. 2d 504 (C.A. 4th).

levied on income within the meaning of the Sixteenth Amendment.

In the first place, there appears to be no constitutional reason why Congress could not impose a tax on gross receipts derived from a business, regardless of the meaning of the Sixteenth Amendment. The power to "lay and collect Taxes" granted to Congress by Article I, Section 8, Clause 1 of the Constitution, is a plenary one, limited only by the requirement that indirect taxes be uniform throughout the United States and by the requirement of Section 2, Clause 3, and Section 9, Clause 4 of Article I (Appendix, *infra*, p. 12) that capitation and other direct taxes should be apportioned among the states in accordance with their enumerated populations. The tax on the income of the taxpayers derived from the contracting business in which they were engaged does not offend the apportionment requirement since it was not a direct tax on property or the income from property. The power of Congress to tax business income without apportionment has long been recognized. *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433; *Nicol* v. *Ames*, 173 U.S. 509; *Spreckels Sugar Refining Co.* v. *McClain*, 192 U.S. 397; *Stratton's Independence* v. *Howbert*, 231 U.S. 399.

Thus it seems that no constitutional objection would exist even if the tax in question could be considered as being on gross receipts, for Congress could levy such a tax as an incidence of its original grant of power under the Constitution. The erroneous notion advanced by the taxpayers (Pet. 6) that the Sixteenth Amendment was a limitation on the power to tax was specifically rejected in *Brushaber* v. *Union Pacific R. R.*, 240 U.S. 1, 11, 17-18, and *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103, 112-113.

Secondly, it is clear that these particular taxpayers are not even being taxed on the gross receipts of their partnership. For the taxable year 1952, the partnership was permitted to deduct from its gross receipts all but $13,535 out of total wage payments of $257,720.72, included in a total reported cost of goods sold of $414,248.59 (Pet. 30-33; R. 69, 70.) Taxpayers were even permitted to deduct illegal wage payments of $48,130, for, due to extenuating and mitigating circumstances, the Commissioner disallowed only $13,535 out of the total illegal wage payment of $61,665. (Pet. 32-34; R. 71.)

Thirdly, Section 405(b) of the Defense Production Act of 1950 is clearly valid under the Sixteenth Amendment. The constitutional term "incomes" has no such rigid and fixed meaning—economic or legal—that it prohibits Congress from declaring that certain unlawful or improper "costs" or "expenses" shall not be considered in computing taxable income, even though such "costs" and "expenses" may actually have been incurred. Cf. *Textile Mills Corp.* v. *Commissioner*, 314 U.S. 326; *Commissioner* v. *Heininger*, 320 U.S. 467, 473-474; *Lilly* v. *Commissioner*, 343 U.S. 90, 94-95, 97; *United States* v. *Sullivan*, 274 U.S. 259, 264. The Commissioner has long had the right to limit the amount of a taxpayer's expenses of doing business to a *reasonable* allowance for wages and salaries, even where such payments were fully legal. (Code Section 23(a)(1)(A), and corresponding sections of prior Revenue Acts, starting with Sections 214(a)(1) and 234(a)(1), Revenue Act of 1918, c. 18, 40 Stat. 1057.) This provision of the revenue statutes is plainly beyond constitutional challenge. The same principle applies to wage payments which are *illegal* and specifi-

cally directed by Congress and valid regulations to be disregarded.[4]

CONCLUSION

The decision below is correct and involves no conflict of decisions or questions requiring review by this Court. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY, 1957.

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[4] The case of *Doyle* v. *Mitchell Bros. Co.*, 247 U.S. 179, on which taxpayers rely (Pet. 7), did not involve any constitutional concepts or the meaning of the Sixteenth Amendment. Nor is there anything in *Eisner* v. *Macomber*, 252 U.S. 189 (Pet. 7) which is helpful to the taxpayers' position here.

APPENDIX

Constitution of the United States:

ARTICLE I

SEC. 2. * * *

Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers. * * *.

* * * * *

Section 8. The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;

* * * * *

Section 9. * * *

No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

* * * * * *

SIXTEENTH AMENDMENT

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Defense Production Act of 1950, c. 932, 64 Stat. 798:

Sec. 405 [as amended by Section 104(i), Defense Production Act Amendments of 1951, c. 275,

65 Stat. 131] (a) It shall be unlawful, regardless of any obligation heretofore or hereafter entered into, for any person to sell or deliver, or in the regular course of business or trade to buy or receive, any material or service, or otherwise to do or omit to do any act, in violation of this title or of any regulation, order, or requirement issued thereunder, or to offer, solicit, attempt or agree to do any of the foregoing. The President shall also prescribe the extent to which any payment made, either in money or property, by any person in violation of any such regulation, order, or requirement shall be disregarded by the executive departments and other governmental agencies in determining the costs or expenses of any such person for the purposes of any other law or regulation, including bases in determining gain for tax purposes.

(b) No employer shall pay, and no employee shall receive, any wage, salary, or other compensation in contravention of any regulation or order promulgated by the President under this title. The President shall also prescribe the extent to which any wage, salary, or compensation payment made in contravention of any such regulation or order shall be disregarded by the executive departments and other governmental agencies in determining the costs or expenses of any employer for the purposes of any other law or regulation.

(50 U.S.C. 1952 ed., Sec. 2105.)

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service,

of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, * * * or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.22(a)-5. GROSS INCOME FROM BUSINESS. In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside

operations or sources. In determining gross income, subtractions should not be made for depletion allowances based on discovery value or percentage of income, selling expenses, or losses, or for other items not ordinarily used in computing cost of goods sold. * * *

General Order 15 of the Economic Stabilization Agency, dated April 3, 1952 (17 Fed. Register 2994, 2995):

SEC. 4. *Disallowance policy.*—(a) *Purposes of disallowance.* The disallowances under the authority granted by sections 2 and 3 may be made for one or more of the purposes of:

(1) Calculating deductions or the basis for determining gain under the Revenue Laws of the United States;

* * * * *

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